SUPREME COURT, U.S.
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NO. 910

IN THE

Supreme Court of the United States

October Term, 1966

SOUTH TEXAS RICE WAREHOUSE CO., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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INDEX

	Page
Opinions of the Courts Below	1
Jurisdiction	2
Statement Concerning The Record	2
Questions Presented	5
Statutes Involved	8
Statement	9
Reasons For Granting The Writ	15
Conclusion	24
Appendix A	27
Opinion of Court of Appeals	27
Judgment of Court of Appeals	42
Order of Court of Appeals Denying Motion For Rehearing	43
Appendix B	44

CITATIONS

CASES

	Page
Anaheim Union Water Company v. Commissioner, 321 F.2d 253	6, 19
C.I.R. v. Brown, 380 U.S. 563	25
Cullers v. Commissioner, 237 F.2d 611, 617	6, 19
Foran v. Commissioner, 165 F.2d 705, 707	6, 16
Gregory v. Helvering, 293 U.S. 465, 469	25
Hanover Bank v. Commissioner, 369 U.S. 672	26
Loesch & Green Const. Co. v. Commissioner, 211 F.2d 210	6, 17, 30
Mayson Manufacturing Company v. Commissioner, 178 F.2d 115	6, 18
J. M. Perry & Co., Inc. v. Commissioner, 120 F.2d 123	6, 17
J. H. Robinson Truck Lines, Inc. v. Commissioner, 183 F.2d 739	6, 16
Turnbow v. Commissioner, 368 U.S. 337	25

MISCELLANEOUS

28 U.S.C., § 1254(1)	2
Sec. 482, I.R.C.	5, 7, 8, 11
Art. 5.10 Texas Business Corporation Act	7, 8

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Petitioner, South Texas Rice Warehouse Co., herein called "Warehouse Company", prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above-entitled case (No. 22,834 below), affirming the judgment of the Tax Court of the United States adverse to petitioner.

CITATION TO OPINIONS BELOW

The opinion of the Tax Court (R. 184-254), is reported in 43 T.C. 540. The opinion of the Court of Ap-

peals (R. 267-283, *infra*, Appendix A, p. 27) is not yet reported.

JURISDICTION

The judgment of the Court of Appeals, affirming the judgment of the Tax Court against petitioner, was entered on August 22, 1966 (R. 285, *infra*, Appendix A, p. 42). On September 12, 1966, petitioner filed its Motion for Rehearing (R. 286-288). Nine copies of that Motion are filed with the Court herewith. The order of the Court of Appeals denying the Motion for Rehearing was entered on October 4, 1966 (R. 297, *infra*, Appendix A, p. 43). Jurisdiction of this Court is invoked under 28 U.S.C § 1254 (1).

STATEMENT CONCERNING THE RECORD

As the record in this case is out of the ordinary, we pray the indulgence of the Court in a short, explanatory statement.

About 1933 five families, Davant, Woods, Savage, Pegram, and L. D. Clements, formed South Texas Water Company, herein called Water Company, to run an irrigation system for rice growing around Rosharon in south Texas. In 1934 L. D. Clements brother, S. M. Clements, incorporated Warehouse Company as its sole owner and had it build at Rosharon the warehouse involved in this case. In 1939 S. M. Clements bought the stock of Woods in the Water Company and sold to the others stock in the Warehouse Company. Several years prior to July 1, 1957, Savage died and the other four families bought his interest in both companies and since that time both have been owned by the Davant, Pegram, L. D. Clements and S. M. Clements families in equal proportions. In the late 1940's

when rice driers were perfected Warehouse Company installed such a drier.

In 1957 the Davant and Pegram families and the children of L. D. Clements and S. M. Clements formed a partnership, South Texas Enterprises (herein called Enterprises), in which the Davant and Pegram families each owned 25% and the children of L. D. Clements and S. M. Clements each owned 25%. L. D. Clements and S. M. Clements, who together owned 35% of the stock of both companies, had no interest in the partnership.

In 1957, after extended argument between the partners in the partnership and L. D. Clements and S. M. Clements, it was agreed that the Warehouse Company should lease its properties to the partnership for $48,000 a year plus the cost of insurance on its properties.

Three years later, in 1960, the Water Company acquired all the assets of the Warehouse Company for $700,000, and the Warehouse Company dissolved and distributed its cash, purely for the purpose of this statement at this point, to its stockholders, who reported their gain on a capital gain basis.

The Government asserted (1) that the partnership was a sham and should be disregarded and (2) that under section 482 of the Internal Revenue Code the rental should be $78,000 a year and the Warehouse Company should be taxed on that basis. The Tax Court held the partnership was valid but the rent should be $78,000 a year.

In the individual case, known below as that of J. E. Davant and Kathryn Davant, et al., the Government contended that the 1960 sale and liquidation of the Warehouse Company was a reorganization of the Warehouse Company

and the Water Company, and that the money received by Davant, et al., was a distribution taxable as a dividend.

Thus the two cases involve entirely separate matters. However, to avoid a duplication in the presentation of evidence, the Tax Court ordered that the Warehouse Company case be tried first and that the evidence taken therein should be considered as evidence in the individual Davant case. We quote the following from the proceedings of the Tax Court (R. 22):

> "The Court:
> The stipulation is now we will try the warehouse case with the stipulation that all evidence taken in the warehouse case will be evidence in the individual cases, but that we will proceed then to try the individual cases for what further evidence is needed."

In the Court of Appeals the Court entered an order reading in part as follows (R. 2):

> "(2) The minutes of the proceedings before the Tax Court on April 23, 1964, covering the proceedings in No. 22,834 and the Findings of Fact and Opinion of the Tax Court therein shall be printed in the printed record only in No. 22,834, but pursuant to the stipulation may be considered by the Court as part of the record in No. 22,835."

In the Court of Appeals for the Fifth Circuit, the *Warehouse* case was No. 22,834 and the *Davant* case was No. 22,835. The taxpayers in both cases are filing simultaneously their petitions to this Court for writs of certiorari. There are being filed with this Court in the *Warehouse* case nine copies of the printed record in No. 22,834 below in addition to the copy certified by the clerk below. In the *Davant* case the petitioners are filing, in addition to the

copy certified by the clerk below, nine copies of the record in the *Davant* case but are not filing an additional nine copies of the record in the *Warehouse* case as they are not available.

The Tax Court handed down one consolidated opinion, set forth in the Warehouse record at R. 184 to 255. As that opinion is set forth therein and is 72 pages in length, we are not printing a copy of that opinion as an Appendix to our petitions for certiorari in either case and pray the Court to refer to it in the printed record in the *Warehouse* case.

QUESTIONS PRESENTED

This petition presents the following important questions involving the proper interpretation of sec. 482 of the Internal Revenue Code of 1954.

1. In determining whether two organizations are owned or controlled by the same interests for purposes of sec. 482, does the phrase "by the same interests" mean "by the same persons" as contended by the Warehouse Company or does it mean "by the same families" as determined by the Court of Appeals? The resolution of this issue is extremely important to the administration of the Federal income tax laws both because of the potentially sweeping effect the interpretation by the Court of Appeals will have on the application of sec. 482 and because it marks the first time that a court has applied the concept of constructive ownership to any section of the Internal Revenue Code other than those sections to which sec. 318 or similar sections are specifically made applicable.

2. Is a determination of fact made by the Commissioner in his notice of deficiency only presumptively true until

evidence to the contrary is introduced or is it in itself evidence of the truth of that fact so that a court is free to disregard in toto the uncontradicted testimony of Warehouse's impartial expert and find for the Commissioner even though there is no evidence by the Government or otherwise to support the Commissioner's position. The Court of Appeals, in substance, so held in this case and in so doing took a position contrary to the holdings of the Fifth Circuit in *J. H. Robinson Truck Lines, Inc. v. C.I.R.*, 183 F.2d 739, and *Foran v. C.I.R.*, 165 F.2d 205; those of the Ninth Circuit in *J. M. Perry & Co., Inc. v. C.I.R.*, 120 F.2d 123, and *Anaheim Union Water Company v. C.I.R.*, 321 F.2d 253; those of the Sixth Circuit in *Loesch & Green Const. Co. v. C.I.R.*, 211 F.2d 210, and *Mayson Manufacturing Company v. C.I.R.*, 178 F.2d 115, and that of the Eighth Circuit in *Cullers v. C.I.R.*, 237 F.2d 611.

3. Where there is no evidence to support the Commissioner's determination of the rental value of the property, and where there is abundant evidence to support the value fixed by Warehouse, is a court authorized to sustain the determination by the Commissioner because, based on purely theoretical economic concepts, not cognizable as a matter of judicial knowledge and not true as a matter of fact or law, the court feels that the determination of the Commissioner is not inherently reasonable? The Court of Appeals so held in this case and in so doing took a position in conflict with the decisions set forth in Question 2 above.

4. Where the undisputed evidence showed that L. D. and S.M. Clements, who together owned 35% of the Warehouse stock and owned no interest in the partnership, actively represented Warehouse and their own personal interests in negotiating with the partnership to ensure that the rent provided for in the lease would be fair and reason-

able, and that, as a result of their arms length long trading session with the partners of Enterprises, forced them to raise their offer of $36,000 a year to $48,000 a year, and where some of the partners testified that they would not have leased the property if the rent had been higher, does sec. 482 authorize the Commissioner and the courts to override this hard fought determination of these taxpayers and to substitute their own ex post facto opinion, unsupported by any evidence, that the rental should be $78,000 a year?

5. Since Article 5.10 of the Texas Business Corporation Act (page 8, infra) required the approval of the holders of 80% of the stock of Warehouse before the lease could be made, and since the approval of L. D. and S. M. Clements was necessary because they owned 35% of the stock, may the Commissioner and the courts say that for the purposes of sec. 482 the Warehouse and Enterprises were under common control merely because children of L. D. and S. M. Clements were in the partnership?

6. Where the whole idea of creating the partnership and leasing the properties originated with the Davants and Pegrams and the next generation of the Clements and the two elder Clements refused to go into the partnership, were the Tax Court and the Court of Appeals justified in holding that the partnership was formed for the purpose of letting the Clements families' children receive a larger part of the income from the drying and storage business?

7. May the Tax Court and the Court of Appeals avoid the rule so firmly established by the decisions cited in Question 2 preceding that the presumption of the correctness of the Commissioner's finding that $78,000 was a reasonable rental is completely overcome where competent evidence to the contrary is introduced, by their holding

certain things were evidence that $78,000 was a reasonable rental when those things were not evidence as to the reasonableness of the rental at all?

8. May the Government stretch the import of sec. 482 to the extent that it can say to honorable, unimpeached taxpayers that they may not carry on their business arrangements established by hard trading but must treat them in such manner as those then representing the Government may thereafter direct even though they never would have gone into them originally on the Government's basis?

STATUTES INVOLVED

Statutory provision involved is section 482 of the Internal Revenue Code of 1954, 26 U.S.C. 1958 ed. sec. 482:

> Sec. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.
>
> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The pertinent provisions of Art. 5.10 of the Texas Business Corporation Act provide that, if a lease of substantially all the property of the corporation is proposed, a meeting of the shareholders shall be called, and it then provides:

"(3) At such meeting, the shareholders may authorize such sale, lease, exchange, mortgage, pledge, or other disposition and may fix, or may authorize the board of directors to fix, any or all of the terms and conditions thereof and the consideration to be received by the corporation therefor. Each outstanding share of the corporation shall be entitled to vote thereon, whether or not entitled to vote thereon by the provisions of the articles of incorporation. *Such authorization shall require the affirmative vote of the holders of at least four-fifths of the outstanding shares of the corporation.*" (Emphasis added).

STATEMENT

From 1933 to 1957 Warehouse was engaged first in rice warehousing and later also in rice drying around Rosharon in south Texas. In 1957 several of the younger stockholders of Warehouse who were active in the management and operation of Warehouse decided that they would like to form a partnership to engage in the rice drying and warehouse business and in connection therewith to lease the assets from Warehouse, and as opportunities might arise to lease other warehouse and drying facilities (R. 27, 51-52). Most of the stockholders were agreeable to going into the new partnership, but S. M. Clements and L. D. Clements were unwilling to do so because, as S. M. Clements testified (R. 132):

"Well, I was not optimistic about the future of the storage business and the drying business at that time. And competition was great, and I chose to go along with my brother for as much rent as we could get out of the younger ones who were going to do the work, anyway. They wanted to take a chance, and I didn't."

In June, 1957, the younger stockholders came to the undersigned, Homer L. Bruce, to ask him to form a partnership agreement for them and to inquire whether they could lease the warehouse property from the Warehouse Company. The undersigned prepared the partnership agreement for them and told them that they could lease the warehouse assets so long as they were willing to pay a reasonable rental for them. After considering the matter, the partners reached the tentative conclusion that a fixed rental of $36,000 a year would be a reasonable rental and suggested that the petitioner lease the properties for that amount. As one of the partners, Mr. Clark, testified (R. 105):

> "We proposed a rental of $36,000, which we thought, in my opinion, I thought was adequate rental, three thousand dollars per month, to operate those facilities. It is quite a responsibility as far as ownership; there is a good deal of liability to be considered in operating a warehouse company and drying rice and storing rice, to be liable for the damaging of it. So I thought $36,000 was very reasonable rent for the lessor."

However, this proposal was unsatisfactory to L. D. and S. M. Clements, as S. M. Clements testified (R. 133, 137):

> "And my brother was of the opinion that fifty thousand dollars was a fair rental, and that was what he was holding out for, which was quite a bit more than they had in mind to begin with.
>
> * * *
>
> "Of course, we were trying to get all the money we could that was coming to us."

In order to resolve this dispute the partners on the one hand and L. D. and S. M. Clements on the other met in

the office of the undersigned Homer L. Bruce to work out a solution. After a long and heated argument lasting approximately two hours, an agreement was reached to lease the facilities for $48,000 a year for one year with an option to renew for two years. However, it was the expectation of all parties that the lease would be continued for an indefinite period of time. In fact the record shows that the lease was still in effect on the date of the trial of the case before the Tax Court in April, 1964 (R. 59-60). Indeed, the lease is still in effect and the assets are still being operated by the partnership as of the date of the filing of this petition.

Upon audit of Warehouse's income tax returns for June 30, 1957, 1958 and 1959, the Commissioner proposed tax deficiencies based on the proposition that all of the income earned by the partnership was the income of Warehouse and in the alternative that under sec. 482 he proposed to allocate $30,000 of such income to Warehouse because of his determination that $78,000 and not $48,000 was the fair rental value.

The Tax Court held against the Commissioner on the first issue and no appeal was taken.

With respect to the second issue, Warehouse contended that sec. 482 was not applicable because the two organizations were not controlled by the same interests and because the rent agreed upon by the parties was the reasonable rent for the properties.

In support of its position Warehouse proved not only the arm's length character of the lease negotiations as discussed above, but proved through the testimony of an impartial expert, as well as by the testimony of parties to the lease transaction, that the fair rental value of the

properties was $48,000. A summary of this evidence is set out in Appendix B at pages 44 to 55 of this petition.

In rebuttal, the Commissioner introduced no testimony or other evidence directly relating to the question of the fair rental value of the property. At most the courts below based their holdings on the following:

1. That in the fiscal years 1955, 1956, and 1957, Warehouse earned a substantial amount of income from the operation of its business.

2. That the leased assets had a fair market value of $700,000.

3. That for the fiscal years 1958, 1959 and 1960, Warehouse suffered a net taxable loss of $33,041.82, $18,011.68 and $12,389.30, respectively, even though during this same period it had enjoyed a net cash gain after taxes of over $150,000 and still owned assets having a fair market value of $700,000.

4. That during the war years of the 1940's, Warehouse in connection with the sale of the entire rice crop, leased the warehouse facilities to the purchaser for $50,000 for a single year (R. 133-134).

5. That a small drying facility located approximately 60 miles away had been leased for a contingent rent of 10 cents per bushel dried and that, if such rate had been used in the Warehouse lease, the rent would have averaged $28,000 per year for the driers alone.

Although all the evidence established both that L. D. Clements and S. M. Clements refused to go into the partnership for bona fide economic reasons, and that they would not agree to let Warehouse lease the assets to the partnership unless a fair rent was paid, the Tax Court

and the Court of Appeals found that the existence of the family relationship between the elder Clements and their children in the partnership and the fact that the elder Clements agreed to the existence of the lease was enough to establish that Warehouse was controlled by the same interests. For example, the Court of Appeals stated (R. 273, 274):

> "We agree with the Tax Court that these businesses were under common control. The statute applies whether the control is direct or indirect. Viewed in the broadest sense, both Enterprises and Warehouse were owned by exactly 'the same interests.' Each family as a unit retained its 25% interest in the income generated by the businesses . . ."
>
> * * *
>
> ". . . The fact that the two elder Clements could veto any reallocation of income even for the short three-year period by blocking the lease of Warehouse's physical properties demonstrates the degree to which the assets involved were to be controlled as they desired."

In so concluding, that court confuses "compromise" with control. A majority of the owners wanted to operate as a partnership. The fact that they agreed to the lease of the properties on condition that an adequate rent was paid shows prudent business judgment, not control.

With respect to the fair rental value of the property, the courts below took the position that the fact that the property had a fair market value of $700,000 was in itself evidence that the fair rental value was $78,000 and not $48,000. The second basis for this holding is that a rental charge which does not produce a net taxable income is ipso facto unreasonably low. (The fact that without risk or

liability Warehouse could in a three-year period net $150,000 after taxes and still own assets worth $700,000 was disregarded.)

In connection with the foregoing we would like to call this Court's attention to the rather strange statement by the Court of Appeals (R. 278):

> "As a result a strange dichotomy developed in the argument of the two cases. In this case Warehouse attacks the Tax Court's finding that the physical properties of Warehouse were worth $700,000, while in *Davant* the petitioners struggle to insure that it will be sustained. Like ourselves, the Tax Court was bothered by this dual argument. Taking the record in this case alone there was little if any evidence showing the assets to be worth less than $700,000, while there was sufficient evidence that they were worth at least $700,000."

We do not understand how the Court of Appeals could have made such an erroneous statement as to our arguments in the *Warehouse* case and in the *Davant* case. In the *Warehouse* case we did not contest that the properties were worth $700,000 but said that that value standing alone was not any evidence under the circumstances as to what a reasonable rental should be. In the *Warehouse* case the Government did introduce a statement by Clark that the property was worth $700,000 (R. 163-164). On the other hand, in the *Davant* case the Government strongly argued that the value was far below $700,000 and even said that the court should take only the depreciated value of the warehouse assets under consideration. Thus it is clear that it was the Government that took these inconsistent positions and not the taxpayers.

Warehouse submits that these facts are not sufficient to permit a person or court not familiar with the area to reach any conclusion as to the rental value of the property. It is apparent, therefore, that the holding of the courts below is based on the erroneously assumed right of the Tax Court to ignore the unimpeached testimony of an impartial expert and find for the Commissioner solely because of the presumption of the correctness of determinations by the Commissioner. As will be shown, this it may not do.

REASONS FOR GRANTING THE WRIT

There is at the present time a conflict among the Courts of Appeals (and even among different panels on the same court) as to whether a determination of fact made by the Commissioner in his notice of deficiency is merely presumptively correct until evidence to the contrary is introduced during the trial or whether the Commissioner's determination is in itself evidence of the truth of his determination. The corollary to this issue is whether the Tax Court in determining a reasonable fixed rent for the lease of business property may disregard all of the sworn uncontradicted testimony of the witnesses, including that of an impartial expert, and, with respect to a matter of which it has no knowledge or experience, exercise its independent judgment as to what the proper rental value is.

The decision of the court below is based on the premise that the Tax Court may disregard all of the evidence in the record relating to the question of reasonable rental value and then sustain the determination of the Commissioner simply by holding that a rental of $78,000 is not "inherently unreasonable". (R. 280).

Petitioner submits that such a rationale should be passed on by this Court because it is erroneous and because it is in conflict with the decisions by various Courts of Appeals discussed immediately below.

The Court of Appeals for the Fifth Circuit, in *J. H. Robinson Truck Lines, Inc. v. Commissioner of Internal Revenue,* 183 F.2d 739, in reversing the Tax Court on a similar question said at page 740:

> "The Commissioner offered no evidence.
>
> "The Tax Court rejected all of the evidence of all of the witnesses, and upon a record containing no evidence whatever supporting them, sustained the Commissioner's determinations that the rents and salaries were excessive.
>
> "Upon settled principles, it cannot do this, and in doing so, it erred. Crude Oil Corp. of America v. Com., 10 Cir., 161 F.2d 809, and the many cases it cites; Foran v. Com., 5 Cir., 165 F.2d 705; Grace Bros., Inc. v. Com., 9 Cir., 173 F.2d 170 at page 174; Howell Turpentine Co. v. Com., 5 Cir., 162 F.2d 319; Mayson Mfg. Co. v. Com., 6 Cir., 178 F.2d 115."

That same Court in *Foran v. Commissioner of Internal Revenue,* 165 F.2d 705, had before it the question of whether a taxpayer Foran had held property as an investment and not for sale to customers. Foran testified that he did hold it for investment. The Tax Court held that it was not held for investment but the Court of Appeals in reversing the Tax Court said at page 707:

> "Here there is direct and positive evidence from the witness who best knows, that this property was for eighteen months being held as an investment and not

held for sale to customers. His testimony is consistent with every proven fact. He gives a credible reason why it was not for sale and why finally in 1941 he did sell it. *We think the court's refusal to follow the sworn testimony is contrary to law, and requires the setting aside of its fact-finding as it would that of a jury.*" (Emphasis added)

In *J. M. Perry & Co., Inc. v. Commissioner of Internal Revenue,* 120 F.2d 123, the Ninth Circuit Court of Appeals said at 124:

"When such evidence has been adduced the issue depends wholly upon the evidence so adduced and the evidence to be adduced by the Commissioner. *The Commissioner cannot rely upon his determination as evidence of its correctness either directly or as affecting the burden of proof. Welch v. Helvering,* 290 U.S. 111, 115, 54 S.Ct. 8, 78 L.Ed. 212; Helvering v. National Grocery Co., 304 U.S. 282, 294, 295, 58 S.Ct. 932, 82 L.Ed. 1346; Helvering v. Talbott's Estate, 4 Cir., 1940, 116 F.2d 160, 162." (Emphasis added).

In *Loesch & Green Const. Co. v. Commissioner of Internal Revenue,* 211 F.2d 210, where the question was in reference to the reasonableness of salaries, the Sixth Circuit Court of Appeals in reversing the Tax Court said at page 211:

"Officers of similar and competing businesses, who were well acquainted with petitioner's business and its officers and their work, testified on the hearing that the salaries paid were 'very much' on the reasonable side, and were in line with the amounts paid for the same and similar services in other construction companies. Their testimony was unimpeached and should have been accepted by the Tax Court *in a matter in*

which it had no knowledge or experience upon which it could exercise independent judgment; and such evidence cannot be arbitrarily disregarded. Capitol-Barg Dry Cleaning Co. v. Commissioner, 6 Cir., 131 F.2d 712. Petitioner's witnesses were qualified, unimpeached, and no evidence was given to the contrary. Their testimony should have been accepted. Wright-Bernet, Inc. v. Commissioner, 6 Cir., 172 F.2d 343. The Tax Court cannot reject the evidence of all of the witnesses and, upon a record containing no evidence to support its decision, make a determination that salaries are excessive. J. H. Robinson Truck Lines, Inc. v. Commissioner, 5 Cir., 183 F.2d 739." (Emphasis added)

In *Mayson Manufacturing Company v. Commissioner of Internal Revenue*, 178 F.2d 115, the Sixth Circuit Court of Appeals in reversing the Tax Court said at page 121:

"This is another case, similar to others referred to herein, where all the testimony before the Tax Court was on behalf of the petitioner. The Commissioner introduced no witness in his behalf. *No witness testified that the compensation fixed by the Tax Court for each of the three officers was in fact reasonable compensation for the services rendered.* We do not know from the record how those figures were arrived at. On the contrary, petitioner's testimony was that the compensation actually paid was reasonable compensation in each instance. No opportunity was afforded petitioner to cross-examine any witness who might have testified for the respondent to the contrary or to test the correctness or fairness of the figures selected by the respondent and the Tax Court. * * * We recognize that in the present case petitioner's evidence on the issue was not from impartial witnesses. *But, nevertheless, it was uncontradicted and was not referred to in the opinion of the Tax Court as being unworthy of belief.* Under such circumstances, the failure of the Commissioner to introduce testimony supporting

> the deductions made by him lends considerable support to our view, gathered from other undisputed facts in the case, that the findings of the Tax Court on the issues involved are clearly erroneous and should be set aside." (Emphasis added)

In *Cullers v. Commissioner of Internal Revenue*, 237 F.2d 611, the Eighth Circuit Court of Appeals, in reversing the Tax Court said at page 617:

> "It would seem that, if the valuation placed upon the real estate by the taxpayers and their witnesses was too low, the Commissioner could have produced some qualified witnesses who would have said so. The lack of such evidence operates against the Commissioner's contentions. See Baltimore Dairy Lunch, Inc. v. United States, 8 Cir., 231 F.2d 870; Mayson Manufacturing Co. v. Commissioner, 6 Cir., 178 F.2d 115."

The two courts below based their decisions that $78,000 was a reasonable rental on the ground that at $48,000 the Warehouse Company showed a loss for the three years involved. How can the fact that the Warehouse Company had a technical income tax loss on the $48,000 rental basis prove that $78,000 was the reasonable rental figure? If the rent is fair, it is immaterial that the Warehouse Company had a taxable loss. This point was forcefully made in *Anaheim Union Water Company v. Commissioner*, 321 F.2d 253 (9th Cir. 1953). There a corporation was in the business of selling water to owners of surrounding land. These owners also owned the stock in the corporation. The price at which the corporation sold the water was insufficient to cover the expenses incurred in gathering it. The Commissioner sought to disallow the loss sustained by the Water Company, on the grounds, among others, that the value of the water was its cost to the tax-

payer. The Court of Appeals forcefully pointed out the fallacy of this position in the following language at p. 260:

> "The opinion assumed the value of the water to be the cost of bringing it to the point where it was delivered to the shareholders, and found the amount of the net income to be the amount by which the value of the water exceeded the amounts paid for the water by shareholders.
>
> "It is evident, of course, that the soundness of this opinion is dependent upon the assumption that the cost of the water was its fair market value. Unless the fair market value of the water exceeded the price which the shareholders paid, the shareholders received nothing more than what they paid for and there was no distribution of income or property. *In the court below, respondent offered no evidence concerning the fair market value of the water. On the other hand, Anaheim had testimony of a competent witness that the charge made by Anaheim for its water was its fair market value; and the witness testified, further, that if the rate had been raised substantially, the result would have been that he and other water users would have sought water from sources other than Anaheim.* In addition, Anaheim produced evidence that SAVI, the water company most comparable to Anaheim, during the years in question charged its shareholders less for water than did Anaheim. The testimony as to the fair market value of the water being uncontradicted and unimpeached, it was not permissible to assume a value at variance with the testimony. . . ." (Emphasis added)

The rationale of the *Anaheim* case is directly in point here.

To sustain this position that the Warehouse Company had these losses the Tax Court gave the following figures for the three fiscal years involved (R. 206):

	Fiscal years ended June 30		
	1958	1959	1960
Total Income	$48,004.73	$49,583.18	$51,199.39
Bad Debts			
Repairs		45.00	55.00
Rents		36.00	36.00
Taxes	5,635.51	5,538.82	6,659.52
Amortization	33,156.89	33,156.89	33,156.89
Depreciation	38,893.42	24,108.32	20,183.74
Other deductions	3,360.73	3,590.27	3,367.09
Interest		119.56	130.45
Total deductions	$81,046.55	$67,594.86	$63,588.69
Excess of deductions over income-loss	$33,041.82	$18,011.68	$12,389.30

The fallacy of such argument is easily pointed out. Of the above deductions those for amortization and depreciation did not involve any cash outlay. Actually when they are offset against the so-called loss, the Warehouse Company for each of said three years was actually better off cash-wise by $120,213.35, without paying any income tax at all, as shown by the following figures, taking into account that amortization and depreciation deductions do not involve cash outlays:

	Fiscal Years Ended		
	6-30-58	6-30-59	6-30-60
Amortization	$33,156.89	$33,156.89	$33,156.89
Depreciation	38,893.42	25,108.32	20,183.74
Total non-cash deductions	72,050.31	58,265.21	53,340.63
Tax loss	(33,041.82)	(18,011.68)	(12,389.30)
Actual net cash gain	39,008.49	40,253.53	40,951.33

Another fallacy is in reference to the amortization figure. The Tax Court pointed out that the Warehouse Company in 1956 had installed new facilities at a cost of $165,784.45. As the Warehouse Company was in the agricultural field, it had obtained the necessary certificate under section 169 of the Internal Revenue Code to allow it to amortize this amount over a period of five years or at the above amortization rate of $33,156.89. The Tax Court then said (R. 239):

> "If the approximate $33,000 a year of amortization on this facility were considered as a fair rental value of that facility, only $15,000 of the $48,000 rental provided for in the lease remains for all of Warehouse's other facilities."

How could the Tax Court say that the Warehouse Company could charge that $33,000 as part of the rent when in five years it would have recovered its entire cost of the new facilities, and then would the Tax Court say that the rent should be reduced by this $33,156.89?

The Tax Court said that a rice drier had been rented for 10 cents a barrel for each barrel of rice dried. (R. 238) Davant had simply testified that he knew of one rice drier far away that had been rented for one year on that basis. (R. 68-69) However, there was nothing to show whether the properties were at all comparable. In addition here was a fixed rent whether any rice was dried or not whereas in that 10 cents per barrel case the rent depended entirely on whether rice was dried or not.

The Tax Court also said that back in 1940 the warehouse properties had been rented for $50,000 a year (R. 238):

> "The evidence shows that during the 1940's when Warehouse's assets did not include a dryer or bulk

storage of any consequence, it leased its facilities for one year at a rental of $50,000."

Actually the only testimony in reference to that was by S. M. Clements (R. 133-134):

"Q. Do you recall the lease of the warehouse facilities in the 1940's, do you recall the lease of the warehouse facilities prior to the building of the dryer, to Mr. Robert Holland?
A. Yes, sir.
Q. What was the lease rental at that time, do you recall?
A. My recollection is that they paid us fifty thousand dollars for one year, for all the facilities.
Q. That was before the construction?
A. That included the personnel and everything.
Q. At that time—
A. They just took over the business.
Q. What was that?
A. Everything that the Warehouse Company owned belonged to Mr. Holland for a year.
Q. What date, do you recall?
A. No, I sure don't."

As there was no evidence to show the nature of the lease to Holland or the surrounding circumstances, and as that lease had been back some time during the war years, it had no bearing on the rental in 1957 and we did not deem it necessary to go into that 1940 lease at all.

Actually, we ask the Government how they came to the rental figure of $78,000 a year? It is perfectly obvious how the revenue agent came to that figure. As pointed out by the Tax Court (R. 206), and as shown on page 21 of this petition, the Warehouse Company reported for the fiscal years of June 30, 1958, 1959 and 1960, losses

of $33,041.82, $18,011.68 and $12,389.30, respectively. These losses had been carried back to the years ended June 30, 1955, 1956 and 1957, respectively, with the result that the District Director had refunded to the Warehouse Company for those years $8,590.87, $17,956.96 and $6,442.44, respectively. (R. 168) By raising the rent from $48,000 to $78,000, or by $30,000 a year, the revenue agent could wipe out these losses for the three years and prevent the Warehouse Company from carrying any losses back to June 30, 1955, 1956 and 1957. This is exactly what the revenue agent did, with the result that the Government reassessed the three amounts above listed for those three prior years. (R. 168) And that is the only basis on which the rent was raised from $48,000 to $78,000.

We submit that there is not one line of evidence in this case to support the Government's contention that the rental should be $78,000.

CONCLUSION

We respectfully urge this Court not to consider this as a simply isolated case. It involves the very fundamental question as to whether honorable taxpaying citizens may conduct their business in a fair and reasonable way without being subject to arbitrary supervision by revenue agents and then subject to the decision of some judge. All of which brings to mind the statement by the Sixth Circuit in *Loesch & Green Const. Co. v. Commissioner of Internal Revenue*, 211 F.2d 210, quoted at pages 17-18 of this petition, as follows:

> "Their testimony was unimpeached and should have been accepted by the Tax Court *in a matter in which it had no knowledge or experience upon which it could*

> *exercise independent judgment;* and such evidence cannot be arbitrarily disregarded."

We respectfully submit that the judge of the Tax Court who heard and decided this case was dealing with the fair rental of a rice drier in south Texas as to which she had no knowledge or experience upon which she could exercise independent judgment.

Those representing the Government in all tax cases now are continually citing *Gregory v. Helvering,* 293 U.S. 465, and saying that the courts must not apply the Internal Revenue Code as written but must look at the substance of a transaction and forget its form. What, however, has become of the rule laid down by this Court in the *Gregory* case at 293 U.S. 469:

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. United States v. Isham, 17 Wall. 496, 506; Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-6; Jones v. Helvering, 63 App.D.C. 204; 71 F.2d 214, 217?"

Actually, this Court in its recent cases and particularly in *Commissioner of Internal Revenue v. Brown,* 380 U.S. 563, *Turnbow v. Commissioner of Internal Revenue,* 368 U.S. 337, and *Hanover Bank v. Commissioner of Internal Revenue,* 369 U.S. 672, has very strongly told the other courts that they must apply the tax laws as they are written and we think that the same rule should apply in this case.

This lease is still in effect in the tenth year, and the properties are now owned by South Texas Water Company. If this case is not decided in favor of the Warehouse Com-

pany, this matter will have to be litigated again by the Water Company for subsequent years because we submit that the taxpayers were right in fixing the rental at $48,000 per year.

We respectfully pray that this petition for a writ of certiorari be granted.

Respectfully submitted,

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APPENDIX A

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 22834

SOUTH TEXAS RICE WAREHOUSE CO., *Petitioner,*

versus

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Petition for Review of Decision of the Tax Court of the United States, (Texas Case).

(August 22, 1966.)

Before RIVES and BELL, Circuit Judges, and FULTON, District Judge.

RIVES, Circuit Judge: This is a companion case to *Davant v. Commissioner,* .... F.2d .... (5 Cir. 1966) (No. 22835). While this case and Davant contain certain common issues of fact, they each involve distinct questions of law. For that reason we have elected to write separate opinions. The Tax Court held that the Commissioner did not abuse the discretion conferred by section 482[1] when he

1. All section references are to the Internal Revenue Code of 1954.

reallocated certain income between South Texas Rice Warehouse Company,[2] the petitioner in this case, and a partnership formed for the purpose of operating the assets of Warehouse. 43 T.C. 540 (1965). We affirm.

The stock in Warehouse was owned by four families, each possessing a one-fourth interest. Within each family unit there was varied division of stock among family members. Warehouse owned drying and storage facilities used to process rice. The rice dried and stored by Warehouse came primarily from land owned by the four families' interests and worked by sharecroppers.[3]

The original storage facilities built in 1936, compared to present day structures, were somewhat primitive. The rice was stored in sacks and was not artificially dried. About 1949 Warehouse constructed a rice dryer and bulk storage facility. Additional bulk storage buildings and machinery were added in 1951 and 1955. A 65,000 barrel bulk storage area costing $165,748.48 was built in 1957. Minor improvements were added throughout the remaining tax years here in question.[4]

In May of 1957, R. Q. Pegram, Jr., E. W. Clark, Thurman S. Clements, and John E. Davant consulted Homer L.

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2. Hereafter, Warehouse.

3. As a general rule, in addition to the rice received as rent and processed through Warehouse, the co-tenants or sharecroppers also dried and stored their rice in Warehouse's facilities. Some rice from independent sources was also dried and stored in Warehouse's facilities. For the relationship of the families' various interests, see our opinion in Davant v. Commissioner, ____F.2d____ (5 Cir. 1966). See also the opinion of the Tax Court. 43 T.C. 540 (1965).

4. The Commissioner seeks to attribute $30,000 of the partnership's income to Warehouse as rent for each of the fiscal years ending June 30, 1958, 1959 and 1960.

Bruce, Esq., an attorney who had represented Warehouse and the four families for many years. They asked whether a partnership could be formed for the purpose of leasing and operating the assets of Warehouse. Bruce told them that this could be done if a reasonable rent was paid for the use of Warehouse's operating assets.

South Texas Rice Enterprises,[5] a partnership, was formed about June 1, 1957. The managing partners borrowed between $15,000 and $20,000 to initiate the partnership, but no other initial capital investment was made.[6] Enterprises, like Warehouse, was owned by the same four families with each family receiving a one-fourth interest.[7] The two older

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5. Hereafter, Enterprises.

6. Another of the families' corporate entities was authorized to guarantee loans to the partnership should that have become necessary.

7.

Individuals	Percent of stock in Warehouse	Percent of ownership of Enterprises in 1957	Percent of ownership of Enterprises in 1958-1960	Percent of family ownership in each
1. L. D. Clements	20			25
2. Thurman S. Clements	2-1/2	12-1/2	12-1/2	
3-4. Betty Dickson Clements Fly and William S. Fly	2-1/2	12-1/2	12-1/2	
5. John E. Davant	7-6/7	10-5/7	7-6/7	25
6. Hortense E. Davant	2-6/7	0	2-6/7	
7. Mary Anne Davant Dunnam	7-1/7	7-1/7	7-1/7	
8. Kathryn Davant Dodson	7-1/7	7-1/7	7-1/7	
9. S. M. Clements	15			25
10-11. Marienne Clements Clark & E. W. Clark	10	25	25	
12. Raye W. Pegram	8	5	5	25

Clements were no longer active in the business. Their shares in the partnership were given to their children, who were active. There was also a slight variance in the distribution of ownership within the Pegram family.[8]

A meeting was held in Mr. Bruce's office at which it was agreed that $4,000 per month would be paid as rental by Enterprises to Warehouse for use of its operating assets.[9] On July 1, 1957, E. W. Clark acting for both Warehouse and Enterprises signed the lease agreement. The lease was for one year with Enterprises given the right to extend the lease one year at a time for two successive years. In June 1960 Warehouse and Enterprises executed another lease susbtantially the same as the first, except that the rent was raised to $4,166.66 per month in order to reflect new improvements made by Warehouse.

Enterprises, like Warehouse, before the leases, was a very successful business venture. The leases, however, separated

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13. R. Q. Pegram, Jr.	8	5	5
14. Joyne Pegram Jones	3	5	5
15. Peggy Pegram Elliott	3	5	5
16. Ray Beth Foster	3	5	5

The persons whose names are indented in the foregoing tabulation were children of the first-named person in the family, except that John E. Davant was the brother of Kathryn Davant Dodson and Mary Anne Davant Dunnam and the nephew of Hortense E. Davant.

8. The partnership was formed for the purpose of letting the Clements families' children receive a larger part of the income generated by the rice drying and storage business. Each of the older Clements told his children that they could have the family's full one-fourth of the partnership if they wanted it.

9. The Tax Court found that the negotiations at this meeting were not arms-length but were merely for the purpose of giving the appearance that a full, fair and reasonable rent was being charged.

the entity that was depreciating[10] the assets from the entity that was receiving the income occasioned by operating the assets. Because of this separation and the fact that the rent paid by Enterprises was not sufficient to cover Warehouse's book expenses, Warehouse showed a yearly loss. Warehouse attempted to carry this loss back to previous years and filed a return asking for a tax refund. The Commissioner objected, taking the position that under section 482 Enterprises' income and expenses should be attributed to Warehouse. In the alternative, the Commissioner contended that the rent paid for Warehouse's assets was insufficient. Under section 482 the Commissioner sought to attribute sufficient income from Enterprises to Warehouse to constitute what the Commissioner conceived to be a reasonable rent, i.e., $78,000.

The Tax Court found against the Commissioner on his first contention. No appeal having been taken from this part of the Tax Court's opinion, we can give the Commissioner no relief. The Tax Court did, however, find for the Commissioner on his alternative argument that $78,000 was a reasonable rent.

Warehouse contends that the Tax Court erred because section 482 should not apply in this case and because $48,000, not $78,000, was a reasonable rent. Section 482 reads as follows:

> "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests,

10. The amounts deducted by Warehouse for depreciation, amortization or other business expenses are shown in the opinion of the Tax Court. 43 T.C. at 549.

> the Secretary or his delegate may distribute, apportion or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such organizations, trades, or businesses."

Two elements must coalesce for the Commissioner to use his section 482 power: 1) The businesses must be under *common control.* 2) The reallocation must be necessary to *reflect* the *proper income* of the businesses or *prevent tax evasion.*

We agree with the Tax Court that these businesses were under common control. The statute applies whether the control is direct or indirect. Viewed in the broadest sense, both Enterprises and Warehouse were owned by exactly "the same interests." Each family as a unit retained its 25% interest in the income generated by the businesses. Individuals who owned 65% of Warehouse's stock owned all of Enterprises'. The only two persons who did not participate in both were the older Clements. Under the circumstances of this case, we do not believe that their lack of absolute control over the assets involved for periods not in excess of three years was sufficient to defeat the operation of section 482.

The purpose of forming Enterprises was to effect a short-term reallocation of income among the family members of certain units without in any way affecting their long-term ownership or control. The Tax Court found (43 T.C. at 560):

> "This partnership was not a sham. It was organized for the business purpose of transferring

> to the adult children of L. D. and S. M. Clements, the fathers' interest in the rice drying and warehousing operation, while permitting the fathers to retain their ownership interests in the physical properties."

In this statement the Tax Court was only half right. Certainly the partnership was not a sham in the sense that it made only a fleeting appearance as a shield for some other transaction. The partnership was a real functional entity intended to last at least from one to three years.

But whether the intention to shift income within a family unit is a "business purpose" justifying its recognition as a distinct noncontrolled business entity must be judged by the statutory function of section 482. The entire purpose of section 482 is to prevent the use of two organizations to distort income or avoid taxes. That purpose would be frustrated if a short-term diversion of income were sufficient to defeat a finding of control where the shift is among related family members and no change takes place in the actual ownership of the "physical properties."

Warehouse argues that the income involved in this case was really generated not by the "physical properties" involved but by the diligent efforts of those managing the business. In this way it is argued that no distortion of income took place and that there is really no identity of ownership of the income generating properties. This argument misses the mark. Not all of those receiving income through either Warehouse or the partnership actually took part in their management. What is more important is that the argument depends upon what is a fair salary for the executives running the business enterprise. Even if all of Enterprises' income were attributable to Warehouse, under

section 482 Warehouse would be entitled to deduct reasonable salaries for its and Enterprises' employees. The question here is whether splitting the distribution of income generated by this business from the entity that retained ownership of the assets can be used to create a tax loss and to receive a refund of back taxes.

Moreover, this record does not show that it was the extraordinary effort of any one individual as opposed to the operating assets of Warehouse and its accumulated good will that generated the income in question. We cannot say that a three-year reallocation of income approved by the elder Clements with a donative intent brought the type of break in continuity of interest or control that would prevent the application of section 482 in this case. See *Advance Machine Exch. v. Commissioner*, 196 F.2d 1006 (2 Cir. 1952), *cert.den.*, 320 U.S. 794; *Cf.* Section 673; also compare *Commissioner v. Owens*, 69 F.2d 597 (5 Cir. 1934).

Warehouse further argues that the requisite common control could not exist, because under Texas law[11] 80% of the stockholders must approve a lease of substantially all of a corporation's assets. The partners of Enterprises owned 65% of Warehouse's stock. Thus at all relevant times they were in effective control of Warehouse, with but one possible exception. That exception is the moment at which Warehouse leased all of its operating assets to Enterprises. If we test control at that moment, the case for the Commissioner is even stronger. Rather than negating an inference of control, the fact that the two elder Clements could veto

11. Article 5.10 of the Texas Business Corporation Act requires "the affirmative vote of the holders of at least four-fifths of the outstanding shares of the corporation" to approve the lease.

any reallocation of income even for the short three-year period by blocking the lease of Warehouse's physical properties demonstrates the degree to which the assets involved were to be controlled as they desired.[12] The only change occasioned by the introduction of the partnership was in who received the income; the business was carried on essentially as before. Such a change of form designed solely to alter the allocation of income in the short run is not the proper occasion for allowing a tax loss to be created by splitting depreciation from income.

Lastly, it is argued that these businesses should be viewed as distinct, uncontrolled enterprises because the partnership had real and distinct liabilities. Chief among these was the $48,000 per year rent that it owed to Warehouse whether or not it had a profitable year. It should be remembered that the partners were practically paying 65% of this rent to themselves as stockholders of Warehouse. Given the family relationship and the fact that the elder Clements had agreed to the lease so that their children could get a larger part of the business income, we conclude that the Tax Court did not err in discounting this factor.

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12. The Tax Court noted (43 T.C. at 526): "Under the facts of the instant case, that common control of Warehouse and Enterprises existed is shown not only by the relationship of father and child with respect to the stockholders in Warehouse who permitted their family interest in the partnership to be taken over by their children but also by the fact that the entire operations of Enterprises were dependent on the overall family interests in various business entities. Obviously, for Enterprises to operate its rice drying and warehousing business, it was necessary that it not only have the lease of the dryer and warehousing facilities of Warehouse but also have available to put through its dryer the rice produced by Rice Farms on lands irrigated and leased from Water Co. Water Co. and Rice Farms were owned by the same individuals who owned the stock in Warehouse."

To repeat, under section 482 control may be indirect as well as direct. As to the family units in the instant case, there was complete identity of control of both entities at all times. As to the individuals, the circumstances of this case require us to find that the three-year lease to related persons does not so interrupt the individuals' control as to prevent the operation of section 482. In the instant case individuals owning 65% of Warehouse's stock owned Enterprises. Within this family context, this is substantial indentity of control viewed in the light of the purpose of section 482. These three factors taken together amply support the Tax Court's finding of control.

The only question remaining is whether the use of Enterprises distorted Warehouse's income so that reallocation is necessary to prevent tax avoidance or to properly reflect income. We agree with the Tax Court that this requisite of section 482 was also fulfilled. Warehouse argues that the lease terms were reasonable and, since $4,000 a month or $48,000 a year was a reasonable rent, that no reallocation of income is necessary. Accepting petitioner's premise that if $48,000 were a reasonable rent Warehouse would be removed from the reach of section 482, we agree with the Tax Court that $78,000, and not $48,000, was a reasonable rent.

The Tax Court found that the physical properties leased to Enterprises were worth $700,000. Originally the records in this case and the *Davant* case were to be printed as a single record on appeal. However, as a convenience to respondent, the Court granted permission to print them separately. As a result a strange dischotomy developed in the argument of the two cases. In this case Warehouse attacks the Tax Court's finding that the physical properties of Warehouse were worth $700,000, while in *Davant* the

petitioners struggle to insure that it will be sustained. Like ourselves, the Tax Court was bothered by this dual argument. Taking the record in this case alone there was little if any evidence showing the assets to be worth less than $700,000,[13] while there was sufficient evidence that they were worth at least $700,000.

In the instant case, Enterprises received more than the physical property of Warehouse, it actually received over 20 years of good will accumulated by Warehouse. Its primary source of supply was another family-owned entity that rented riceland on a sharecrop basis.

Prior to the lease, in fiscal years 1955, 1956 and 1957 Warehouse's net income was respectively $130,710.77, $171,021.42 and $75,594.29. Enterprises' respective net income[14] for 1957, 1958, 1959 was $127,400.12 (from July 1, 1957—December 31, 1957), $75,967.89, $109,978.13.[15] As a result of confining the income to Enterprises, Warehouse showed a loss of $33,041.82 in 1958, $18,011.68 in 1959, and $12,389.30 in 1960.[16]

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13. Mr. Clark at one time estimated the value of the assets as about $600,000.

14. Enterprises' gross receipts, prior to paying its $4,000 per month rent and other expenses, were much higher than its net income. For example, from July 1, 1957 to December 31, 1957 Enterprises had gross receipts of $219,577.96.

15. Had the entity Enterprises not been used during this period, Warehouse would have had net profits of $151,400.12 (from July 1, 1957-December 31, 1957), $123,967.89, $157,978.13. This figure is reached by adding back the rent paid to Warehouse which was deducted in arriving at Enterprises' net profits.

16. Thus a $123,967.89 net profit on the drying and storing business was turned into a $33,041.82 loss in 1958 and a $157,978.13 net profit was turned into a $18,011.68 loss in 1959. (It should be noted that these figures do not adjust for the variance in fiscal years.)

The Tax Court suggested a number of ways to compute a reasonable rent. One witness had heard of a small drying facility on the periphery of the rice-growing area that rented its properties for 10 cents per barrel of rice dried. During 1940 Warehouse had leased its less sophisticated storage facilities for one year at a rental of $50,000.[17]

The Tax Court indicated that if Enterprises rented just Warehouse's drying facilities at a 10 cent per barrel dried rent, it would have paid approximately a $28,000 per year rental. If Enterprises also rented Warehouse's storage facilities for $50,000, the total rent would be approximately $78,000.[18]

Warehouse points out that the 10 cent per barrel rental referred to was not one where there was an absolute liability, as here. That is to say, here Enterprises must pay $48,000 per year rent whether it dries rice or not, while there if no rice was dried no rent was paid. For the reasons stated earlier when we discussed the element of control, we do not think that the absolute $48,000 rental alters this case. Nor would a rental of $78,000 for property and good will worth in excess of $700,000 be inherently unreasonable.

Nothing in this record explains why a corporation which enjoyed the earnings record of Warehouse and which could have enjoyed the earnings record of Enterprises would, just after completing a new storage facility costing over $165,000, lease its properties for $48,000 per year, a sum not sufficient to cover its fixed book expenses. The conclusion

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17. This lease was made before Warehouse built any drying facilities or added the more modern storage facilities involved in its lease to Enterprises.

18. For a more detailed explanation of this method of computing Enterprises' rent, see the opinion of the Tax Court, 43 T.C. 540 (1965) at 550-51.

is inescapable, that if Enterprises' income were not going to family members the lease would not have been consummated, i.e., no independent party could have negotiated such a lease in an arms-length transaction.

Warehouse emphasizes that rice drying is a risky business and that a storm might destroy the entire rice crop. Thus, it says, $48,000 is a reasonable rent. This assumes that the family actually would force collection of the rent regardless of industry conditions. For the reasons we have stated before, the Tax Court did not err in discounting this factor. The earnings record of Warehouse and Enterprises also belies this contention. When Enterprises was created, the purpose was to reallocate income. Both Warehouse and Enterprises faced the same risks and there is no reason to allow this entity under the circumstances of this case to be used to create a tax loss and refund of income by artificially severing depreciation and amortization from the income generated by operating the business.

Warehouse had the burden in the Tax Court of proving that $78,000 was not a reasonable rent. It also had the burden of proving what was a reasonable rent if $78,000 was not reasonable. The weight and sufficiency of the Commissioner's evidence is challenged by petitioner who also argues that it has carried its burden.

Warehouse argues that the government put on no evidence of its own and that the partners and their "expert" testified that $48,000 was a fair rental. From this we are to conclude that the Tax Court as a matter of law could not find to the contrary. See *J. H. Robinson Truck Lines v. Commissioner*, 183 F.2d 739 (5 Cir. 1950) (where no evidence to the contrary, the Tax Court must decide for petitioner). We think the rule is otherwise. Judge Hutcheson in *Hightower v. Commissioner*, 187 F.2d 535 (5 Cir.

1951), at 536, distinguished his opinion in *J. H. Robinson Truck Lines*, and this Court had occasion to reexamine the problem in *Burford-Toothaker Tractor Co. v. Commissioner*, 192 F.2d 633 (5 Cir. 1951).

In *Burford* the petitioner called four witnesses who gave their opinions and the Commissioner called none. This Court said (192 F.2d at 635):

> "In the present case in addition to the opinions of the witnesses there was factual evidence from which reasonable inferences could be drawn. * * *
>
> * * * * * *
>
> "The Tax Court was not concluded by the opinions of the witnesses."

We think the rule is clear, the Tax Court is not bound by the conclusory statements of any witness, even an "expert." The Court must look at the substance of a witness' testimony as well as his conclusions. The testimony must be weighed along with all other relevant evidence. Here the Tax Court pointed out that the witnesses overlooked several significant factors in reaching their conclusions. The Commissioner relied on the testimony adduced from petitioner's witnesses both during direct and cross-examination and the other evidence in the record. The only question is whether the Tax Court's finding that $78,000 was a reasonable rental was clearly erroneous in view of all of the evidence in this record. *San Marco Shop, Inc. v. Commissioner*, 223 F.2d 702 (5 Cir. 1955); *Burford-Toothaker Tractor Co. v. Commissioner*, 192 F.2d 633 (5 Cir. 1951), *cert. den.*, 343 U.S. 941 (1952); *Stein v. Commissioner*, 322 F.2d 78 (5 Cir. 1963); *Golden Const. Co. v. Commissioner*, 228 F.2d 637 (10 Cir. 1955); *Oswald Co., Inc. v. Commissioner*, 185 F.2d 6 (7 Cir. 1950).

Taking this record as a whole, we cannot say that the Tax Court's factual finding that $78,000 was a reasonable rental was clearly erroneous. The purpose of section 482 is to prevent just such tax avoidance or income distortions as occurred here.[19] *Hall v. Commissioner*, 294 F.2d 82 (5 Cir. 1961); *Tennessee Life Insurance Co. v. Phinney*, 280 F.2d 38 (5 Cir. 1960); *Grenada Industries Inc. v. Commissioner*, 17 T.C. 231 (1951), *aff'd*, 202 F.2d 873 (5 Cir. 1953), *cert. den.*, 346 U.S. 819; *Advance Machine Exch. v. Commissioner*, 196 F.2d 1006 (2 Cir. 1952), *cert. den.*, 320 U.S. 794. The opinion of the Tax Court is therefore

AFFIRMED.

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19. When the same persons control two or more entities they may cast their transactions between those entities in any form that they desire. The restraining force of outside interests is absent. Section 482 is designed "to prevent evasion of taxes" or distortion of income caused by the form that these persons choose in casting their transactions.

United States Court of Appeals

FOR THE FIFTH CIRCUIT

October Term, 1965

NO. 22,834

D. C. Docket No. 1048-63

SOUTH TEXAS RICE WAREHOUSE CO., *Petitioner*

versus

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

Petition for Review of Decision of the Tax Court of the United States (Texas Case)

Before RIVES and BELL, Circuit Judges, and FULTON, District Judge.

JUDGMENT

This cause came on to be heard on the petition of South Texas Rice Warehouse Co. for review of a decision of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the decision of the Tax Court in this cause be, and the same is hereby, affirmed.

August 22, 1966

Issued as Mandate:

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 22,834

SOUTH TEXAS RICE WAREHOUSE CO., *Petitioner*
versus
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Petition for Review of Decision of the Tax Court of the United States (Texas Case)

ON PETITION FOR REHEARING

(October 4, 1966)

Before RIVES and BELL, Circuit Judges, and FULTON, District Judge.

PER CURIAM:

The petition for rehearing filed by the petitioner in this case is hereby DENIED.

APPENDIX B

The undersigned Homer L. Bruce, who had represented these rice people since around 1933, said in his opening statement on the trial of this case on April 23, 1964 (R. 27):

> "The younger ones wanted to form a partnership to go into the rice drying business and farming, themselves, not only for the rice drying proposition, but other parts of the country, although they have not expanded.
>
> "So, in July—in June of 1957, these partners, the younger ones, formed a partnership called the South Texas Rice Enterprises. Then they proposed to lease the warehouse property from the South Texas Rice Warehouse Company.
>
> "They met in my office and I advised them that they had the right to do it if they wanted to, but that they must pay a reasonable rental. That would be an issue. [24] And it might be litigated. So they had quite an argument there in my office there. Some of them starting out at thirty-six thousand — Dick Clements wanted fifty thousand dollars, and they finally agreed to forty-eight thousand dollars rental. The lease was made July 1, 1957, for $48,000 a year.
>
> "The lease—I forget—I think it ran three years, but it had the option to—they had the option to extend it. The warehouse company later put in about thirty thousand dollars more property, and the rental was raised to fifty thousand dollars.
>
> *"That lease is still in effect, Your Honor.* * * *"

John E. Davant testified that he was 52 years of age and had been in the rice business all of his life with his father, W. E. Davant (R. 42-43). Up until the early 1940's

there was no machinery for drying rice but about that time a new method was developed under which rice could be dried and the Warehouse Company put in a dryer in 1948. The general business of petitioner was to dry rice for farmers and store it for them in the warehouse if they desired. He further testified:

"Q. State whether or not you and Bob Pegram, that's R. Q., Jr., and Eddie Clark, and at that time, Thurmon Clements, came up to see me some time in May, 1957, about the possibility of forming a partnership and leasing this property from the Warehouse Company.
A. We did.
Q. Do you recall, in substance, what I told you about it?
A. Yes, sir.
Q. What was that?
A. You said that we could lease the property but we would have to pay a reasonable rent.
Q. You then asked me to get up the partnership agreement, did you not?
A. Yes, sir, we employed you to do that for us.

* * *

Q. Now, what was your purpose in going into that partnership agreement, Mr. Davant?
A. Well, I felt like—
Q. What caused you to want to go into it?
A. I felt like it was an opportunity for us to make some money at that time. And, of course, we had discussed the possibility of even leasing a mill and leasing other properties. (R. 51-52).

* * *

"Q. Now, did you finally come to any agreement with the other stockholders that didn't go in, Mr. S. M. Clements and others, how did you come to an understanding that this first year, or the rental under

the first lease would be forty-eight thousand dollars a year or four thousand dollars a month?

A. We came up to your office and we had been discussing it on the basis of three thousand dollars a month—

Q. Now, who was up there? You said "we."

A. Thurmon Clements, E. W. Clark, R. Q. Pegram, Jr., and myself, and I believe Dick Clements or L. D. Clements and S. M. Clements.

Q. They were there?

A. Yes, sir.

Q. What did you all do about fixing the rent, Mr. L. D. Clements and S. M. Clements not being in the partnership, how did you come to a figure?

A. We made an offer of $3,000 a month, coming to $36,000 a year. Dick wouldn't hear to it. He wanted fifty thousand dollars cash.

We finally, after, I guess, about an hour of argument or a little longer, arrived at $4,000 a month. We wanted it on a monthly basis. And that was $48,000, and he finally agreed to that.

Q. What was Mr. S. M. Clements' attitude about your thirty thousand and fifty thousand dollars?

A. Mr. S. M. Clements was right along with Mr. Dick Clements. They wanted what they considered a better rental than we had offered them, They didn't want to lease it and wouldn't agree to it until we came up with a forty-eight thousand dollar figure.

Q. Well, now, Mr. Dick Clements owned twenty per cent of the stock at that time, and S. M. Clements owned fifteen per cent, and they wouldn't agree to any lease unless you did come up?

A. That's correct.

Q. You say you were there about an hour and a half?

A. We were there longer than that, but at least that one thing was discussed for at least an hour and a half. (R. 53-54).

* * *

"Q. All right.

Mr. Davant, if that rent, if they had demanded $78,000, like the government is claiming in this case, as the rent, state whether or not you would have gone into this partnership and, rented it for $78,000 a year.

MR. FRIEDMAN: Objection. The question calls for conclusion on the part of the witness.

"THE COURT: It calls for an opinion, but I am receiving it. I have grave doubts, Mr. Bruce, how much this is worth because it's something that didn't happen, and it's highly speculative, but I am receiving it purely as his opinion of what he might have done. The Court will let him answer.

"A. No, sir, I wouldn't. But I would like to explain that. (R. 54-55)

* * *

"BY MR. BRUCE:

"Q. Mr. Davant, from your opinion and your experience, do you think this $48,000, and later $50,000 a year was reasonable rent to pay for this property?

A. I thought it was high.

Q. You thought it was above the value?

A. Yes, sir, and I do now. (R. 68).

Edward W. Clark, whose wife is Marienne Clements Clark, the daughter of S. M. (Spence) Clements, testified:

On July 1, 1957, he had been President of petitioner for many years and has since been the managing partner of the partnership. (R. 101).

"Q. Mr. Clark, you have heard Mr. Davant testify as to the formation of the South Texas Enterprises, and I believe the record shows that on July 1, 1957, when that lease went into effect, Mr. S.

M. Clements owned fifteen per cent of the stock of the Warehouse Company and you and your wife owned ten per cent, but when you formed the Enterprises, you and your wife owned twenty-five per cent?

A. Yes, sir.

Q. Now, tell the Court why you wanted to go into this Enterprises partnership and go into this activity?

A. Well, I started to work down in Rosharon down in 1948 when they built the dryer, and had been there from 1948 to 1957, which is about nine years. The previous five to that, I was probably manager, president and manager of the Warehouse Company with a ten percent interest and an average small salary.

With my ten percent interest in the Warehouse Company, I wasn't actually realizing much income from those facilities. And I was in favor of trying to have the opportunity of making some additional income. And through a partnership — Mr. Clements wasn't interested in going into it for whatever his reasons might be — and I could acquire, my wife and I could acquire a full twenty-five per cent interest. If there was to be any income, I would be benefited from that, rather than have a ten per cent in the corporation.

Q. Now, what was Mr. Clements' attitude about going into such a partnership?

A. He said he didn't want any interest in the partnership, at the meeting at your office, that if I wanted a full twenty-five per cent of it, I could have it, which was a family proportion.

* * *

Q. You had that meeting, testified to by Mr. Davant, in my office. Do you recall when you had it and came to an agreement as to what the rental would be?

A. Yes, sir, I recall.

Q. And just tell the Court briefly what happened there and what the attitude of Spence Clements and L. D. Clements and S. M. was and what your attitude was.

A. We proposed a rental of $36,000, which we thought, in my opinion, I thought was adequate rental, three thousand dollars per month, to operate those facilities. It is quite a responsibility as far as ownership; there is a good deal of liability to be considered in operating a warehouse company and drying rice and storing rice, to be liable for the damaging of it. So I thought $36,000 was very reasonable rent for the lessor. And Mr. Dick Clements thought it should be more. I don't know whether it was forty-eight or fifty or fifty-two, or whatever figure it was, but we finally decided, or he made a remark, that forty-eight would be all right with him.

And he said, 'Well, boys, I don't think I want any part of it, a partnership. I don't want any part of it. But you all are young. If you go busted or broke, you have a chance to come back. But I am older and I don't want any liabilities from damaging of rice that you boys don't realize could happen to you.'

Q. So he refused to go into it?

A. Yes, sir. His brother, Spence Clements, I imagine felt the same way after Mr. Dick expressed his opinion. Anyway, he told me if I wanted a full twenty-five per cent, I could have it. He didn't want any of it.

Q. Would you have gone into it and rented that if Mr. Dick Clements held out for higher rent?

A. I don't think so. I might have paid fifty thousand dollars, but that would have been the most I think I would have paid, in my opinion, at that time, and I would have paid less." (R. 105-106).

* * *

William S. Fly, the son-in-law of L. D. (Dick) Clements, testified:

"Q. Mr. Fly, you have been present during the testimony and have heard the testimony with reference to the formation of South Texas Enterprises partnership and the leasing of these properties from the Warehouse Company. It's been testified that you were at the conference in my office when it was finally agreed, in June, 1957, the first rent would be $48,000?

A. Yes, sir.

Q. Would you tell the Court, briefly—when I say briefly, in the light of what has been testified—as to whether or not what happened there was substantially the same as Mr. Davant and Mr. Clark testified to?

* * *

A. My recollection is substantially the same. My father-in-law, Mr. Dick Clements, did not want to go into it. We argued with him relative to the amount of rental, as Mr. Davant and Mr. Clark said.

Q. State whether or not there was considerable discussion as to what the lease would be.

A. There was considerable discussion and we were putting some pressure pretty good on Mr. Dick to try to get this rent down to where we thought we could make some money.

Q. And you didn't think that was going to endanger your marital relationship with your father-in-law?

A. No. We worked on it pretty hard, but he went along with it finally.

Q. Why did you want to go into this?

A. I wanted the opportunity to make some money.

Q. You had a bigger increase in the percentage, an increase in the Enterprises than you had in the Warehouse Company?

A. That is true." (R. 127-129).

S. M. (Spence) Clements testified that he built the first warehouse and then in 1939 bought into the South Texas Water Company.

"Q. Sometimes I call you by your first name because I don't remember the Mister.

"Spence, state whether or not when this matter of forming the South Texas Rice Farming Enterprises came up, did you want to be a partner?

A. I did not.

Q. Why?

A. Well, I was not optimistic about the future of the storage business and the drying business at that time. And competition was great, and I chose to go along with my brother for as much rent as we could get out of the younger ones who were going to do the work, anyway. They wanted to take a chance, and I didn't.

Q. How much work did you do on the Warehouse Company or the Farms?

A. Well, I haven't done any in a long time, Homer.

Q. All right.

"Now, state whether or not you know what the legal liability of a partner is in a partnership and what can happen to you.

A. Yes, sir, I think I do know.

Q. What is your idea?

A. My idea is that a partner is liable for everything, everything his partner is due and him, too. There is no limit.

* * *

Q. You have heard the testimony here as to the conference that was had in my room when Mr. Davant, Mr. Pegram, Bill Fly and you and Dick Clements were there, and how you came to arrive at $48,000 a year?

A. Yes, sir. I remember we argued back and forth quite a while. And my brother was of the opinion

that fifty thousand dollars was a fair rental, and that was what he was holding out for, which was quite a bit more than they had in mind to begin with. But we finally settled on four thousand dollars a month.

Q. Did you go along with Dick?

A. I went along with Dick, my brother. (R. 131-133)

R. Q. Pegram, Jr. testified that he was the son of the original R. Q. Pegram and that Raye W. Pegram is his mother and his sisters are Joyce Pegram Jones, Peggy Elliott and Raye Beth Foster; that he had been connected with the Water Company since 1949 and has been its President since prior to 1957 (R. 139-140).

"BY MR. BRUCE:

Q. Mr. Pegram, you have heard the witnesses testify about the conference that was had between members of the Rice Enterprises partnership and Dick Clements and Spence Clements and myself up in in my office about how this was fixed?

A. Yes, sir.

Q. Were you at that conference?

A. Yes, sir.

Q. What was your thought at that time as to what rent you should pay?

A. I thought thirty-six thousand dollars a year or three thousand dollars a month was entirely adequate and all we could afford to pay.

Q. What was Mr. Dick Clements' attitude?

A. Mr. Dick Clements' attitude was that it should bring at least fifty thousand dollars a year into the corporation.

Q. And you finally agreed on forty-eight thousand dollars?

A. Yes, sir, four thousand dollars a month.

Q. State whether or not, Mr. Pegram, there are inherent risks that occur in the rice drying business that might cause some years to be good and some years to be bad.

A. That is true.

Q. What are some of those risks?

A. Your risks from hurricanes, loss of crops in the field, intermittent weather conditions that delay orders, rush of business at various times over and above what your capacity will permit you to take in. You have to divert rice to other areas. There is always the danger in handling the rice through the drying process that someone may be neglectful and the rice will be damaged; the operator of the facilities would certainly be liable for any damages suffered to the rice. (R. 141-142)

Marcus W. Mauritz testified that he was 55 years old, he had no connection with the petitioner or any of the people interested in it or in the Water Company, that his father was one of the leading businessmen and farmers around Ganado, Texas, some 75 miles from where the petitioner had its operations and that he had been in the rice business all of his life.

"Q. Now, will you tell the Court what connection you have had with the rice business and particularly the rice drying business and the rice storing business in the last years, up to July 1, 1957, and on up to date, particularly prior to July 1, 1957.

A. Well, being the only son in all of this family you are just speaking of, I was more or less started out as errand boy, then grew up to more or less managing them. And in about 1942 I took over the active management of all the rice farming.

"And in 1945 we built the second dryer that was built in Texas, and we have operated that dryer

ever since, and I have been the active manager of it.

"Prior to building the dryer in 1945, we operated, as has been brought out here today, warehousing where we took in sacked rice and stored it in the warehouses and sold it for the farmers.

"Since 1957, actually in 1949, I helped organize what is called Texas Rice Promotional Association, a voluntary organization that has its main object as promoting the consumption of rice in the United States. It has since been merged into a rice council, which is now a national organization that still has the same objects. And our principal concern is how much rice is produced, how much of it is sold, where it's sold, and how much we can increase the sales so as to increase the production that the farmer is allowed to produce.

* * *

Q. Mr. Mauritz, you have heard the testimony here in connection with the facilities down there at the Warehouse Company, and I will ask you if you have seen a copy of the lease that was executed effective July 1, 1957, from South Texas Rice Warehouse Company to South Texas Rice Enterprises.

A. Yes, sir, I have.

Q. And that lease, I believe, provides for a rental of forty-eight thousand dollars per year for those facilities.

A. Yes, sir.

Q. Now, to refresh your memory, Mr. Mauritz, I would like to show you Petitioner's Exhibit No. 18, which gives the annual receipt of rough rice at the Rosharon dryer, and that is the South Texas Rice Warehouse Company, during the crop years from 1949 to 1963. I will ask you whether or not

you have seen a copy of that and have studied it heretofore.

A. Yes, sir, I have.

Q. And you are more or less familiar with the volume that went through that rice dryer down there?

A. Yes, sir.

Q. Now, Mr. Mauritz, have you become personally familiar with the business properties at Rosharon that constitute this South Texas Enterprises rice warehouse and dryer?

A. Yes, sir, I have.

Q. I believe the record shows that they have a silo with a capacity of 65,000 barrels, a quonset warehouse of 36,000 barrels, and a dryer of 36,000 barrels and a warehouse of 137 by 400 feet, with the machinery that goes along with such a warehouse.

"Now, Mr. Mauritz, from your experience in the rice business, state whether or not in your opinion the rental of $48,000 that was provided for in this lease effective July 1, 1957, would be a reasonable rental to pay for the rent of this warehouse property.

A. In my opinion it is excessive. (R. 149-152)